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BEFORE THE

SURFACE TRANSPORTATION BOARD

EX PARTE NO. 582 (SUB-NO. 1)
MAJOR RAIL CONSOLIDATION PROCEDURES

OPENING COMMENTS OF PPL ELECTRIC UTILITIES CORPORATION AND PPL MONTANA LLC

PPL Electric Utilities Corporation ("PPL Utilities") and PPL Montana LLC commend the Board for instituting this proceeding. There is no more important issue facing carriers, shippers and the Board than the issue of how to restructure rail regulation during the short period before major railroads become free to pursue further consolidation.

I. SUMMARY OF COMMENTS

This proceeding presents a much-needed opportunity to provide a better balance in the relationships among major railroads, shippers, and smaller railroads, within the scope of STB jurisdiction. As the result of past consolidations, and other ICC and Board decisions, Class I railroads have been able to manage their operations with an extraordinary degree of freedom from regulatory interference and from competition by other railroads.

If the years since 1980 had produced among railroads the same kind of entrepreneurship and customer responsiveness that have been demonstrated by the trucking industry, there might be no need for this proceeding. But the major railroads, which have resisted competition and effective regulation, have used their freedom to pursue consolidation. The result has been increased concentration of market power, poor service, and indifference to customers' concerns. Even the modest competition that shortlines and regional railroads might have provided has been curtailed.

Before things get worse through further mergers, the Board must act. The proposals in its March 31, 2000 Decision instituting this proceeding are a good start, and these initiatives should be pursued in the next phase of this proceeding. Of particular value are the following proposals.

- Promoting and Enhancing Competition. This is the Board's most important new initiative. Rail mergers are not without their benefits, but those benefits are all too often compromised by the resulting reductions in competition. Past policies have attempted to address these concerns, but have not gone far enough. The Board can and should impose conditions on future mergers that will create new competitive options for shippers. Major gateways should be preserved, new through routes should be ordered, and the Board's "one lump" theory and its use of trackage rights relief only for "2-to-1" shippers should be abandoned.

- Shortline Railroad Issues. One of the best ways the Board can promote competition is through the elimination of anticompetitive provisions in line sale contracts and trackage rights agreements between Class I railroads and shortline and regional railroads. Major railroads have used these provisions to reduce competition from smaller railroads while reducing competition among themselves through mergers. This must stop.

- Safeguarding Rail Service and Other Benefits. The UP/SP merger and the breakup of Conrail have caused unacceptable service problems. A system of guarantees and penalties is needed to prevent any recurrence. More fundamentally, the Board should hold major merger applicants to their promises, and order remedial action when merger implementation produces fewer benefits or more harms than anticipated.

In addition to these initiatives, the Board must take steps to prevent major railroads from recovering acquisition and merger implementation costs from captive shippers. If Class I railroads can simply raise captive shippers' rates to recover the costs of any reforms adopted in this proceeding, the reforms will fail to achieve their intended results.

Finally, the importance of promoting competition is so great that the Board should propose initiatives in this area that go beyond merger proceedings. Specifically, the Board should eliminate the general requirement (which does not appear in the statute) that shippers must show anticompetitive railroad conduct as a prerequisite to relief under 49 U.S.C. § 11102 or under the Board's Intramodal Rail Competition regulations. This change is necessary to help shippers that are currently remediless. It is also necessary to prevent non-merging railroads from enjoying unfair advantages as compared with future merger applicants.

II. INTEREST OF PPL ELECTRIC UTILITIES CORPORATION AND PPL MONTANA LLC

PPL Utilities is the corporate successor to Pennsylvania Power & Light Company, an investor-owned electric utility headquartered in Allentown, PA. As owner and operator of large coal-fired generating stations in Pennsylvania, PPL Utilities continues to be a major coal shipper, and continues Pennsylvania Power & Light's long practice of active participation before the ICC and STB in major proceedings affecting the interests of captive rail shippers.

Despite being one of the largest coal shippers on Conrail, Pennsylvania Power & Light found it necessary to file two rate cases against Conrail, when Conrail refused to provide service at reasonable rates. The second of these rate cases, Docket No. 41295, had to be expanded to name CSX and Norfolk Southern as additional defendants, and was one of the three rates cases at issue in the STB's Bottleneck proceeding. The case was settled subsequent to the filing of the parties' opening statements, and Conrail was absorbed by NS and CSX.

As a result of these experiences, PPL Utilities is well aware of the way consolidations of major railroads have served to decrease competition, constrict shippers' service options, reduce service quality and reliability, and facilitate monopoly pricing.

PPL Montana is an affiliate of PPL Utilities, established to operate coal-fired generating facilities recently acquired in Montana. PPL Montana is captive to Burlington Northern Santa Fe at its J.E. Corette Steam Electric Station in Billings, MT, which generates electric power for sale in the new competitive power marketplace. PPL Montana, like PPL Utilities, has first-hand knowledge of the inadequacy of negotiations with a market dominant railroad, as an alternative to effective regulatory or competitive remedies.

III. BACKGROUND OF THIS PROCEEDING

PPL Utilities and PPL Montana (hereafter collectively "PPL") participated actively in the Ex Parte No. 582, Public Views on Rail Consolidation. That proceeding (which led to this one) was precipitated by the announcement of the intended merger of BNSF and Canadian National, and by the reaction to that announcement by the other major North American railroads.

NS and CSX, which dominate rail freight in the eastern United States, and Union Pacific and Canadian Pacific, which are the sole major rail competitors of BNSF and CN for freight in the West, made their position starkly clear. They stated unambiguously that if the BNSF/CN merger proceeding went forward, the four remaining major railroads would pursue their own consolidations, threatening a North American rail duopoly in a few short years.

To its credit, the Board realized that the process of rail consolidation had reached a point of no return, and it received comments and heard testimony from a broad spectrum of interested parties, including all of the major railroads, many smaller railroads, rail labor, other carriers, shippers and shipper associations of all kinds, and governmental interests.

The positions taken by the major railroads came as no surprise. BNSF and CN want their merger proceeding to go forward, and have gone to court to challenge the STB's moratorium on major rail consolidations. The other major railroads want the BN/CN merger delayed to provided more time for them to prepare for their own consolidations, so they support the STB's moratorium. No major railroad wants any change in the Board's merger policies or other regulatory policies. The only change the railroads want in competition is to decrease it through further mergers.

The surprises came in the testimony of the other parties to Ex Parte No. 582. For many years now, the railroads have used wedge issues to divide the shipper community. This strategy has generally involved attempts to pit customers with competitive options against captive customers by telling the former that they would be hurt by any relief for the latter. See, for example, the volume of supporting letters from shippers filed by the railroads in the <u>Bottleneck</u> proceeding. As a result, shipper opinion before the Board has often been split, while the railroads have spoken with one voice. Even the smaller railroads whose survival is threatened by anticompetitive paper barriers in contracts with larger railroads toed the AAR line.

All this changed in Ex Parte No. 582. Shippers of all types and sizes (including some of the largest companies in America, and companies that have heretofore avoided STB proceedings), small railroads, other carriers (including UPS, in its dual capacity as a motor carrier and a railroad customer), and governmental interests, including USDA and DOT, all expressed similar concerns.

It is true, as the STB found in its March 17, 2000 Decision in Ex Parte No. 582, that there was widespread shipper opposition to proceeding with the BN/CN merger proceeding on a "business as usual" basis. PPL therefore fully supports the Board conclusion, set forth in its Ex Parte No. 582 Decision and reiterated in its March 31, 2000 Decision instituting this proceeding, that existing merger regulations are inadequate to today's challenges and must be revised.

However, with considerable unanimity, shippers and other interested parties (excluding major railroads) opposed further consolidation (and sometimes only further consolidation beyond BN/CN) <u>not</u> in order to prevent a good situation from going bad, but to prevent a bad situation from getting worse.

PPL's Comments in Ex Parte No. 582 provided a particularly comprehensive overview of the problems facing shippers now, and those Comments are incorporated herein by reference. But many other shippers also commented on problems they face in dealing with today's rail duopolies (NS and CSX in the East, and BN and UP in the West).

Many of these problems are merger related, such as the service problems following the UP/SP merger and the breakup of Conrail, and the ease with which railroads can recover merger-related expenses by simply increasing rates on captive traffic.

Other problems may have their origins in rulemaking proceedings or adjudications, but have been exacerbated by the consolidations of the last two decades. These include the ineffectiveness of existing procedures for dealing with anticompetitive conduct, including foreclosures of access by incumbent railroads, and the inadequacy of existing constraints on railroad differential pricing. The stand-alone cost methodology works well only for point-to-point bulk shippers, and does not deter unlawful pricing. Many shippers have no effective rate remedy. See PPL's Comments in Ex Parte No. 582 at 7-14.

There is a very real danger that in 15 months (if not sooner), the Board will be asked to deal with one or more merger applications that will produce two massive North American railroads that would provide even less rail-to-rail competition than we have today, and would also be less subject to effective regulatory remedies. Because the Board's existing merger procedures would be the vehicle for creating these enormous rail systems, the focus in this proceeding on amended merger regulations may be understandable. However, the Board should not ignore other issues, and is to be commended for inviting comments not just on the changes listed in its March 31 Decision in this proceeding, but also on "any others that commenters would like to propose" (Decision at 5).

IV. <u>THE BOARD MUST EXPAND THE SCOPE OF THIS PROCEEDING TO CONSIDER MORE THAN CHANGED MERGER RULES</u>

As detailed below, PPL supports many of the initiatives proposed in the Board's March 31 Decision. However, the Board's list should be expanded to include merger-related issues not cited in that decision, and issues that go beyond merger concerns. Some of these issues are also detailed below, and others may be suggested by other parties. There are several reasons why the scope of this proceeding must be expanded.

In the first place, the legitimacy of the complaints about the status quo brought before the Board in Ex Parte No. 582 is not a function of whether they are, or are not, merger-related. If shippers' problems would be made worse by further consolidations, they are germane to this proceeding.

Second, such issues as the vulnerability of captive shippers to the extraction of unlawful prices, or to the foreclosure of access to competition, may be significant factors in the incentive of railroads to merge. To the extent that future mergers would be driven, at least in part, by the ease with which acquisition costs can be recovered from captive shippers, that incentive should be addressed here. The Board has acknowledged the need to address the problem of mergers that create more captive traffic, but appears to ignore the danger of mergers that merely permit two railroads to combine and exploit their existing captive customer bases.

Third, if captive shippers remedies are improved vis-a-vis future merger partners but remain inadequate vis-a-vis existing railroads, the result could be discriminatory treatment based on the happenstance of whether a shipper is captive to a post-2001 or pre-2001 merged railroad. Two sets of laws would exist side-by-side, and competing shippers could have unequal remedies.

In addition, the first railroads to merge could be disadvantaged in comparison to their competitors. For example, if BN/CN merged, subject to new protections for services and shippers resulting from these proceedings, BN/CN might be vulnerable to poaching by UP, CSX, NS or CP, in that the non-merging railroads might be entitled to serve BN/CN customers through trackage rights or open gateways, but BN/CN would have no reciprocal opportunity to compete for new business from customers captive to UP, CSX, NS or CP.

Leaving these issues out of this proceeding, on the theory that they could be addressed in subsequent rulemaking proceedings, could present legal and procedural difficulties, in addition to the practical problems of which examples are provided above. In the future, prospective merger partners might argue that they negotiated their consolidations in reliance on the Board's decision to consider changes in merger rules, but not in other regulatory policies, and that absent notice of changes, it would be unlawful for the Board to, for example, restrict their ability to recover merger costs from captive shippers when CSX and NS experienced no such disability.

In the sections of these Comments that follow, PPL will begin with the changes in merger regulations as to which the Board requests comments in its March 31 Decision. However, for the foregoing reasons, PPL will then address other needed changes in rail regulations.

V. THE BOARD'S DECISION HIGHLIGHTS SEVERAL AREAS THAT REQUIRE REFORM

In its March 31, 2000 Decision in this proceeding, the Board identifies a number of important issues. All deserve consideration, but PPL will address only the following.

A. Downstream Effects Should be Considered

It is past time for the Board to stop considering merger applications in isolation. PPL therefore agrees that 49 C.F.R. § 1180.1(g) should be amended to permit consideration, in all future merger proceedings involving a Class I railroad, of downstream effects. This proposal should not require extended discussion, since it is likely to be supported by most, if not all, commenting parties.

B. Rail Service Improvement Promises Should be Enforced

In the past, merging railroads have consistently promised that their consolidations would lead to better service for shippers. All too often, these promises were accepted at face value. Even when consummation of the merger did not produce service disasters, there has been little attention paid to the question of whether the railroads' service promises were kept. This should change.

It should not be particularly difficult to measure service quality pre and post-merger. The Board has gained valuable experience in gathering data on service as a result of its Emergency Service Order proceeding during the UP meltdown, and in the aftermath of the breakup of Conrail. "Before" and "after" data addressing such criteria as equipment supplies, time required to fill car or train orders, loading times, transit times, terminal congestion, unloading times, out of service equipment, cargo loss and damage levels, and other indicia of performance can be collected and compared.

It is important to require pre-merger data that goes back several years, in order to prevent artificial post-merger service "improvements" as compared with poor service immediately prior to the merger. Even assuming no desire to "lower the bar" just before a merger, railroad management that is preoccupied with a planned consolidation may not produce a reliable baseline.

PPL has no objection to requiring the submission of the merger applicants' plans for insuring that promised service improvements materialize, and (possibly even more important) that pre-merger service levels are maintained. However, actions speak louder than words. It has become customary recently for the Board to retain jurisdiction over rail mergers to monitor implementation of merger conditions. This should continue, and should definitely include periodic reporting on the quantity and quality of rail service.

A more difficult question concerns the actions that should be taken when promises are broken. The BN and CN proposed the use of service guarantees, though the details were vague. PPL supports the idea of service guarantees backed up by penalties for non-performance. The exact nature of those guarantees may have to be worked out on a case-by-case basis, inasmuch as different situations may call for different remedies. However, the concept should be explored further and approved in this proceeding.

C. **<u>Merger Benefit Claims Should be Tested</u>**

The fundamental statutory standard for approval of rail mergers reads as follows: "The Board shall approve and authorize a transaction under this section when it finds the transaction is consistent with the public interest." 49 U.S.C. § 11324(c). As the Board explained in its Decision in Finance Docket No. 33388, approving the breakup of Conrail: "To determine the public interest, we balance the benefits of the merger against any harm to competition or to essential service(s) that cannot be mitigated by conditions." Decision at 47.

Under the circumstances, it is not surprising that the applicants in rail merger proceedings claim enormous public benefits for their proposals, and minimize harm to competition. There is an obvious incentive to overstate the former and understate the latter (and there are parallel but reverse incentives for merger opponents).

The difficult task of weighing the various parties' claims, many of which are necessarily projections and estimates, falls to the STB. However, there has been relatively little follow-up to determine whether the merger applicants' or merger opponents' balancing of benefits and harms was most accurate.

PPL recognizes that the Board is not prescient, and cannot know in advance whether all projected benefits or harms will in fact occur. On the other hand, it is often within the power of applicants whose consolidation is approved to implement their merger in such a way as to produce the projected benefits, and to avoid or minimize the harms to competition projected by merger opponents.

This may require more expense and effort than the consolidating railroads anticipated, leading to difficult choices, which become even more difficult to the extent that the railroad does not simply recover merger implementation costs from captive customers. Does it settle for fewer benefits or more harm to competition than the Board expected when it approved the merger, or does it work harder and spend more to preserve that benefit/harm ratio?

As with the issue of service safeguards, there are strong reasons for the Board to compare actual benefits and harms with projected benefits and harms, and there is no good reason not to perform this comparison, particularly in view of the disappointing results of recent mergers. The necessary data and measurements will vary, depending on the particular benefit or harm, but much of the analysis should be straightforward. However, the main burden of data production must obviously be borne by the merged railroad, since it will have the most complete information.

Here too, however, the more difficult question is not whether to conduct the analysis, but what to do when there are significant differences between projections and reality.

The Board can and should condition its approval of further railroad consolidations on the actual realization of projected benefits and the actual avoidance of competitive harms. The Board also should position itself to order remedial action by the merged railroad to enhance benefits or mitigate harm to competition whenever actual benefits, or measures to mitigate harms, fall short of meeting their goals.

However, there is an obvious danger that merger applicants will, in effect, gamble with captive shippers' money. To prevent this, and to preserve the integrity of merger proceedings, the Board must place the risk of failure where it belongs. At a minimum, it should adopt a rebuttable presumption that the costs of remedial action to redress imbalances in benefits and costs are to be borne by railroads and their stockholders, not shippers. Consideration should also be given to competitive remedies, such as trackage rights, to enhance benefits or mitigate harms.

D. Competition Must be Enhanced

The most important step the Board can take in this proceeding is to adopt new approaches that serve to enhance and promote competition. The dominant trend of public policy with respect to regulated industries in the last two decades has been the growth of competition in place of pervasive rate and service regulation.

In trucking, see Central & Southern Motor Freight Tariff Assn. v. United States, 757 F.2d 301, 311 (D.C. Cir.), cert. denied 474 U.S. 1019 (1985), in which the court of appeals observed that in the Motor Carrier Act of 1980, Congress adopted "an approach emphasizing market discipline, in contrast to public utility-style ratemaking, as the principal regulator of motor carriers." As this agency is well aware, competition has revolutionized the trucking industry, bringing major benefits to the carriers and their customers.

Similar changes have brought new efficiencies to industries that, like the railroads, had been considered natural monopolies. These include telecommunications, the natural gas pipeline industry, and the electric power industry.

Many of the arguments the railroads always raise against increased rail-to-rail competition are the same arguments that were raised by electric utilities against deregulation. They were rejected as to the electric power industry, and they should also be rejected as to railroads.

PPL has been a leader among the companies calling for more competition in its industry. There is thus no inconsistency in PPL's call for greater competition in the railroad industry. On the contrary, more rail competition is necessary for the success of a more competitive electric power industry.

In the past, many captive electric utilities could pass on to their rate payers the costs resulting from railroad abuses of monopoly power, such as high rail rates and the expense of maintaining large coal stockpiles due to poor or unreliable rail service. It is to the industry's credit that, despite this option, so many utility coal shippers worked so hard to preserve shippers' rights and remedies in proceeding after proceeding before this agency.

Now, however, PPL and other operators of coal-fired electric generating facilities serve a far more competitive marketplace, and excessive rail rates can mean lost sales, the closing of power plants, and even company failures. While it is clearly not in the railroads' interest to jeopardize the survival of the electric power industry as a whole, railroads may be indifferent to, or in favor of, a restructuring of the industry, to suit their preferred routing patterns, train sizes and delivery schedules. Accordingly, the reduction in railroad competition that has already taken place, through past consolidations and through barriers to effective competition by smaller railroads, is of grave concern to PPL. Unless this proceeding leads to significant reforms, further consolidations will only make things worse.

Ironically, the first steps toward promoting railroad competition come in the Staggers Rail Act of 1980, in the same year that the trucking industry was largely deregulated. In the Staggers Act, Congress called for greater reliance on competitive solutions, with regulatory remedies reserved for problems arising from the absence of effective competition.

The fundamental policy of the Staggers Act, and the logic of competitive versus regulatory solutions to the prevention of abuse of monopoly power, set up an inverse relationship. More competition permits less regulation. Conversely, where strong regulatory remedies exist, less competition may be tolerable, though it has become clearer with passage of time that competition is preferred.

In the railroad industry, there was a third factor in the equation: memories of pre-1980s financial problems in the railroad industry, and Congressional concern for railroad revenue adequacy. All too often, this factor led to he worst of both worlds for shippers, namely, less effective regulation and less railroad competition.

Since 1980, the ICC and STB have had more authority to enhance competition than the agency has chosen to exercise. In the non-merger context, see 49 U.S.C. § 11102, which authorizes the Board to order terminal trackage rights or reciprocal switching where "practicable and in the public interest."

In the context of railroad consolidations, the ICC and the Board have been urged repeatedly to impose merger conditions designed to enhance or promote competition. The agency has generally declined to adopt these recommendations, but has never contended that it lacked the power to implement them. The ICC and Board have instead elected on policy grounds to adopt conditions designed only to preserve pre-existing competitive options or to mitigate merger-related competitive harm.

Even this goal has not been fully achieved in practice, due to the tendency of the ICC and Board to define competitive harm narrowly, and employ conditions sparingly. This tendency has been unfortunate, because the absence of pro-competitive conditions is more harmful to shippers than the presence of such conditions is to railroads.

When the Board errs by failing to impose a pro-competitive condition that is needed, it creates a captive shipper, or exacerbates the shipper's vulnerability. In contrast, when the

Board errs on the side of imposing a pro-competitive condition that was unnecessary, the railroad may not lose any business at all.

The ICC and Board have defended their resistance to the imposition of pro-competitive conditions by stating that they do not want to undermine the merger's benefits. But surely this is putting the cart before the horse. Conditions should be adopted wherever they are justified, and only then should the public benefits be weighed against the residual harm to competition.

E. <u>The One-Lump Theory Should be Abandoned</u>

A particularly egregious theory that has been put forward by the railroads in support of limits on remedial action to address the competitive harm caused by mergers is the so-called "one lump" theory.

Under the "one-lump" theory, it is presumed that wherever any shipper is served by a single railroad, that railroad is extracting all available monopoly rents. This presumption has led, in turn, to certain highly questionable assumptions about the limits of possible competitive harm from mergers.

Two hypothetical examples involving PPL should illustrate how the one-lump theory leads to an excessively narrow definition of competitive harm. Assume that PPL wants to bring fuel to its Pennsylvania generating stations, which are captive to NS, from Powder River Basin mines served by BNSF and UP. Today, the mines served by BNSF and UP would compete for PPL's business, and BNSF and UP would presumably compete with each other to haul coal to the point of interchange with NS.

Assume now that NS were to merge with BNSF. Under the one-lump theory, PPL would suffer no competitive harm, because all monopoly rents are already being extracted by NS. But this analysis ignores the fact that competition from UP, and from UP-served mines, would be lost. It also ignores the possibility that NS is <u>not</u> extracting all monopoly rents, either because its limited participation in coal sales and deliveries prevents it from knowing what the market will bear, or because it fears retaliation from UP and BN if it maximizes its profit on the haul.

The result for PPL, the one-lump theory notwithstanding, is likely to be fewer coal choices, costlier or less suitable coal, and higher rail rates over the portion of the haul where there was formerly competition between UP and BNSF. But PPL's complaints about competitive harm in a BN/NS merger proceeding would be brushed aside. (There might be public benefits, or even benefits to PPL, from such a merger, but assigning a zero value to the competitive harm side of the scale obviously produces a tilt toward merger approval.)

Now assume a variation on the foregoing hypothetical. Instead of merging with NS, the BNSF merges with UP. Allowing a single railroad to control all shipments of Powder River Basin coal would obviously be a competitive disaster, and it is a virtual certainty that rail rates from the Powder River Basin to the point of interchange with NS would rise, forcing PPL to pay more for PRB coal as a result of the merger, or else forego the coal. And yet, the one-lump theory would assume no harm to PPL from a merger of the UP and BNSF because NS is presumed to be charging such high rates to PPL already that no higher rail rates are possible.

Indeed, no shipper that is not directly served by the UP or BNSF could assert a claim of competitive harm that would be given any weight by the STB in a UP/BNSF merger proceeding. As a result, the entire eastern half of the country would effectively be disenfranchised. Assuming the one-lump theory was appropriate for smaller-scale merger proceedings in the past, its assumptions are untenable in the context of future mergers, and the theory should be abandoned.

Adding to the objectionable nature of the one-lump theory is the fact that it is used to deny shippers an effective voice in merger proceedings due to circumstances -- their captivity -- for which there is no other effective remedy. The Board may say to a shipper complaining about high rates in a merger proceeding that the shipper's remedy lies in a rate case (assuming the shipper is one of the few for whom a stand-alone cost case offers some relief). It may make sense to avoid addressing, in complex merger proceedings, issues that can be resolved in a separate proceeding. However, the Board's position is that it will not impose conditions "to ameliorate longstanding problems which were not created by the merger." Conrail Decision, supra, at 78.

The problem with this position is that it treats competition as something to minimized rather than promoted, and ignores the possibility that, outside the merger case context, there may be no other remedies. For example, ICC and Board interpretations of 49

U.S.C. § 11102 and their application of the "Competitive Access" remedies have rendered relief under those provisions illusory. Preserving shipper captivity should not be a goal of STB regulatory policy in any context. Such a policy is particularly objectionable in the context of a major rail merger, where the Board's powers are at their height.

The Board has the authority to use its merger approval authority to impose conditions that provide relief not otherwise available to captive shippers, in the interest of enhancing the merger's benefits. In failing to exercise this authority, it has parted company with other regulatory agencies that often exercise their merger jurisdiction in this way, and with the FTC and Department of Justice, which also routinely condition merger approval on the applicants' acceptance of conditions designed to produce public benefits.

F. The Board Should Also Rethink its "2-to-1" Policy, and Should Explore Other Pro-Competitive Initiatives

An adjunct to the Board's one-lump theory, and to its general reluctance to adopt pro-competitive positions, is the Board's rule that the loss of rail service must be remedied through trackage rights or switching only when a shipper goes from service by two railroads before the merger, to service by one railroad after the merger. Shippers going from service by three railroads to two get no relief.

The "3-to-2" issue is less pressing today than in the past, because previous mergers have led to eastern and western rail duopolies, and fewer shippers are served by three railroads. Moreover, smaller railroads rarely provide effective competition due to paper barriers and other obstacles imposed by major railroads (which are discussed below).

The fact remains that there is no basis in the statute for ignoring "3-to-2" shippers. On the contrary, 49 U.S.C. § 11102 provides for trackage rights or reciprocal switching remedies whenever "practicable and in the public interest." In restricting merger case relief to "2-to-1" shippers, the Board has adopted the most restrictive possible interpretation of its remedial authority.

However, the fundamental issue in this proceeding is whether this policy of minimizing the use of pro-competitive conditions remains sound in today's more heavily concentrated rail marketplace. For reasons explained above, PPL submits that the Board can and should take prompt steps to expand shipper access to pro-competitive conditions in merger proceedings. It should no longer be assumed that 3-to-2 shippers suffer no loss of competition.

Similar reasoning supports not just the preservation of open gateways for all major routings, but the creation of new gateways, and new through routes, wherever appropriate. In addition, merger partners must not be allowed to preserve the appearance, but not the reality, of open gateways, through the simple expedient of switching charges that render the gateways useless.

Switching "at an agreed-upon fee" for all shippers within or adjacent to terminal areas, as discussed in the Board's Decision instituting this proceeding (at 7) raises the same concern. The larger railroads become, and the more expansive their service territories, the more necessary it becomes for the Board to be concerned about duopoly collusion rather than duopoly competition. Switching charges must be kept reasonable if mandatory switching is to be an effective remedy for increased market power and/or anticompetitive conduct.

The Board concludes its section on "Promoting and Enhancing Competition" (Decision at 7-8) with two measures intended to prevent mergers from undermining the "contract" exception to the ability of railroads to avoid regulatory scrutiny of their bottleneck rates. As one of the principal shipper parties to the Bottleneck proceeding, PPL regards that decision as erroneous, and violative of the fundamental Staggers Act policy in favor of allowing competition to set rates where it exists (notwithstanding equivocal case law from decades earlier on railroad routing initiatives).

It goes without saying that the ability of railroads to exploit bottleneck monopolies should not be enhanced through mergers.

G. Shortline and Regional Railroad Competition is Essential

As the number of Class I railroads decreases, it becomes imperative that the Board address the problem of contractual and other barriers to competition between Class I and smaller railroads. Rail-to-rail competition can be implemented with the least difficulty and the most effectiveness where the potential competitors are nearby, and shortlines are often operating close to shippers whom they cannot serve due to paper barriers.

The remedy of trackage rights loses much of its appeal for a competing railroad if too many miles of the incumbent's tracks must be traversed, and too much of a premium paid in trackage rights charges, crew costs, etc. Further mergers will produce even larger rail systems, with even greater distances between Class I railroad interchange points.

For this reason, enhanced competition for many shippers will be difficult, if not impossible, without the participation of shortline and regional railroads. Today, the smaller railroads are an underutilized asset, constrained as they are by anticompetitive provisions in line sale contracts and trackage rights agreements.

PPL Montana has firsthand experience of these constraints. Switching service for its Corette generating station is provided by Montana Rail Link. However, PPL Montana understands that Montana Rail Link cannot quote rates or provide service without BNSF approval except for traffic that originates and terminates on Montana Rail Link. Naturally, BNSF uses its power over Montana Rail Link to limit competition from the smaller railroad.

The Board has been aware of these problems for some time, having acknowledged them in its Decision instituting Ex Parte No. 575, Review of Rail Access and Competition Issues. In a decision served March 2, 1999 in that proceeding, the Board deferred action on a shipper request for a rulemaking proceeding to eliminate paper barriers.

The Agreement between the Class I railroads and smaller railroads approved by the Board in 1998 in Docket No. S5R 100, Association of American Railroads and American Short Line and Regional Railroad Association -- Agreement -- Application under 49 U.S.C. § 10706, has proved to be inadequate to overcome Class I resistance to competition by the smaller roads. In Ex Parte No. 582, the American Short Line and Regional Railroad Association stated that the very survival of the smaller railroads is in jeopardy. The smaller railroads through their trade association, as well as individual smaller railroads including Montana Rail Link, called on the STB for relief from the anticompetitive terms of their arrangements with Class I railroads.

In the next phase of this proceeding, the Board should, at a minimum, propose to condition its approval of further mergers involving Class I railroads upon such railroads' agreement to waive anticompetitive provisions in line sale and trackage rights agreements with shortline and regional railroads.

VI. THE BOARD SHOULD ALSO AMEND ITS MERGER PROCEDURES TO PRECLUDE RECOVERY OF MERGER COSTS FROM CAPTIVE SHIPPERS

In its Conrail Decision, supra, at 62-67, the Board addressed warnings by shippers that NS and CSX had paid too much for Conrail, and should not be allowed to simply recover the overpayment from captive customers. This would amount to funding major rail consolidations with other people's (i.e., captive shippers') money.

The Board rejected the shippers' arguments at that time, relying on representations by NS and CSX that they would "have much more than a sufficient flow of funds to meet their financial obligations without having to raise rates at all." Decision at 63. The Board projected an increase in the jurisdictional threshold of roughly 5-7%, but expressed confidence that these increases would not occur. To its credit, however, the Board stated that it would "continue carefully to assess the impact of this transaction on both the jurisdictional threshold and the revenue adequacy status of NS and CSX, and incorporate this within the oversight condition we are imposing here." Decision at 67.

As the Board knows, many projections by NS and CSX have not been borne out by experience, and CSX recently announced plans for widespread rate increases, and reduced use of contracts in order to permit even more rate increases in the future. True to its word, the Board included the issues of revenue adequacy and the jurisdictional threshold in its February 9, 2000 Decision in Finance Docket No. 33388 (Sub-No. 91), calling for reports and public comments on implementation of the Conrail breakup.

It is odd, but presumably inadvertent, that the issue of recovery from captive shippers of the costs of implementing major rail mergers, including the costs of corrective action when things go wrong, was not specified as an issue in this proceeding. This issue must not be overlooked. <u>Simply stated, there can be no worse message sent to the Class I railroads than that they are free to</u>

<u>fund future consolidations through rate increases on captive traffic</u>.

All of the reforms under consideration in this proceeding will be undermined, if not vitiated entirely, if the costs of the major railroads' errors of planning, judgment and execution can simply be charged to their captive customers. Instead of being penalized when they over-promise or under-perform, railroad management would be protected. Rigorous post-merger scrutiny of the extent to which projections were accurate would be a sham. And there would be <u>no</u> disincentive for future consolidations, even if pursued hastily and recklessly.

Class I railroads will be able to pursue their goals of expansion, rendering even more customers and territories "exclusively served," and there will be no downside. If the consolidations work as advertised, railroad management and shareholders win; if they don't, shippers lose. Under these rules, why shouldn't railroads consolidate, and pay whatever it costs to outbid any rivals?

The likely response of the railroads is that they are doing the best they can (pouring enormous resources into their mergers), and that captive shippers must fund their consolidations because they have no other source of revenues. This is unacceptable. As the <u>UP/SP</u> and <u>Conrail</u> cases have shown, the best these railroads could do was not good enough. And reliance on captive customers as the funders of last resort is a variation on the "too big to fail" problem the Board cited in its Decision initiating this proceeding.

When utilities obtain authorization from federal and state regulatory authorities to merge, great care is taken to insure that the costs and risks are not borne by ratepayers. Rates are often frozen for many years, to insure that the merger partners look only to the gains from their consolidation to cover its costs. This system is fair, efficient, and has proved its worth in the utility field. The Board should propose such procedures for any future rail mergers.

PPL is aware that the Board's rate jurisdiction is limited. However, its merger jurisdiction is extremely broad, and would support such a condition. Notably, former 49 U.S.C. § 10707a(h), which prohibited the ICC from using its authority to prescribe reasonable rules, classifications and practices in order to limit rail rates, was deleted in the ICC Termination Act of 1995, and has no current counterpart.

VII. ISSUES OUTSIDE THE MERGER CONTEXT ALSO REQUIRE URGENT ATTENTION

It is understandable for the Board to want to be prepared for the possibility that, in 15 months, it will have to begin considering not just the BN/CN merger, but also other applications that may constitute the "end game" for railroad consolidation in North America. The initiatives discussed in the March 31, 2000 Decision should be pursued, along with other merger-related reforms discussed herein.

However, the Board should not ignore the fact that part of the impetus for railroad mergers has been the limited extent to which their market power has been constrained by effective regulation. Captive coal shippers like PPL are grateful for the remedies available to them, but too many shippers believe, with justification, that they have no recourse to regulatory remedies. These attitudes were extensively documented in the recent GAO reports, and even the railroads cannot seriously contend that the Board's competitive access remedies or maximum rate guidelines for non-coal shippers have been effective. No one uses them.

PPL appreciates that this proceeding, and the time available before the moratorium expires, do not permit a "complete overhaul of the existing regulatory system," as noted in the March 17, 2000 Decision in Ex Parte No. 582. However, a focus solely on the STB merger regulations would be too restrictive. The focus should rather be on ways of promoting competition as a counterbalance to past and future reductions in competition as the railroad industry has pursued its goal of duopoly.

The Board has already recognized that merger procedures should not be its exclusive concern in this proceeding, by acknowledging the need for further action on paper barriers to competition from shortline and regional railroads. The Board should also propose, in the next phase of this proceeding, changes in its competitive access rules to reconsider one of the ways the current regulatory environment promotes major rail consolidations. One the railroads' arguments in favor of consolidation on terms that do not promote competition is that regulation in general, as practiced by the ICC and Board, has not promoted competition.

This should change, because more competition is desirable whether or not there are more mergers, and because railroads should not be able to argue against pro-competitive conditions in future mergers on the ground that the Board is discriminating against merger applicants vis-a-vis their non-merging competitors.

It is also important for the Board to put the remaining Class I railroads on notice that they cannot rely on continued reluctance by the agency to fully implement the trackage rights and reciprocal switching remedies of 49 U.S.C. § 11102, absent a shipper showing of railroad anticompetitive conduct. If the Board were to exclude this issue from this final comprehensive review of regulation prior to the final round of mergers, post-merger reform would be rendered more difficult. The resulting transcontinental railroads could argue that they were entitled to rely on the rules in place at the time they planned their consolidations, and that those rules should not subsequently be changed.

The railroads should not be heard to object to expanding this proceeding to address competitive access more generally. In their Report of the Association of American Railroads on Railroad/Shipper Discussions Relating to Competitive Access and Revenue Adequacy, filed July 17, 1998 in Ex Parte No. 575, Review of Rail Access and Competitive Issues, the railroads proposed a number of modifications in Board procedures on competitive access.

The railroad industry's reforms were far more limited than those proposed by shippers, and were not agreed to by shippers. However, the point is that the issue was accepted as a legitimate area for discussion by railroads and shippers, and that those discussions addressed competitive access issues in general, without assuming further mergers. It is all the more appropriate that this issue be discussed further in the next phase of this proceeding.

Accordingly, PPL urges the STB to propose that competitive access remedies under 49 C.F.R. Part 1144, and the Board's interpretation of 49 U.S.C. § 11102, will no longer require a threshold showing of anticompetitive conduct by a railroad before relief can be ordered.

VIII. CONCLUSION

For the foregoing reasons, PPL urges the Board to develop proposals in the next phase of this proceeding reflecting these Comments.

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Dated: May 16, 2000

CERTIFICATE OF SERVICE

I hereby certify that I have caused a copy of the foregoing pleading to be served on all parties of record by first-class mail, postage prepaid, this 16th day of May, 2000.

John M. Cutler, Jr.

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